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In the Supreme Court of the United States

OCTOBER TERM, 1953

No. 530

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

C. P. CHAMBERLIN,[1] GRACE A. CHAMBERLIN, JOHN H. TONER, ET AL.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

The Acting Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that

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[1] These cases involve income tax liability of six individuals who owned practically all of the common stock of the same corporation. The cases present a common issue, and were consolidated for hearing both in the Tax Court and the court below. (R. 51-52, 81.) The record was made and filed below only in the case of *C. P. Chamberlin* v. *Commissioner*, with the stipulation that the decision in that case is to govern the decision in the others. (R. 81-83.) A separate judgment was entered in each case. (R. 87-91.) For convenience the cases will be referred to in the singular, while the respondents will sometimes be collectively referred to as the taxpayers or the stockholders.

writs of certiorari issue to review the judgments of the Court of Appeals for the Sixth Circuit, reversing the decisions of the Tax Court in the instant cases.

OPINIONS BELOW

The opinion of the Tax Court (R. 51-78) is reported at 18 T.C. 164. The opinion of the Court of Appeals (R. 91-103) is reported at 207 F. 2d 462.

JURISDICTION

The judgments of the Court of Appeals were entered on October 14, 1953. (R. 87-91.) The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

Preferred stock was issued to the common stockholders of a corporation in the form of a stock dividend, and was contemporaneously transferred by them to previously selected purchasers on previously negotiated terms for a cash price equal to the par value of the dividend stock, both steps being taken in execution of a preconceived plan for avoiding a dividend tax on a direct distribution of the corporation's accumulated earnings. The question is whether the stockholders received a dividend distribution taxable under Section 115(a) and (b) of the Internal Revenue Code, as the Tax Court held, or a non-taxable stock dividend under Section 115(f), as the Court of Appeals held.

STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of the statute and Regulations appear in the Appendix, *infra*, pp. 26-29.

STATEMENT

The facts as stipulated (R. 34-50) and found by the Tax Court (R. 52-63) may be summarized as follows:

Taxpayers owned 99.7 per cent of the outstanding common stock of the Metal Mouldings Corporation (hereafter called the Metal Company or the corporation), a Michigan corporation long engaged in the manufacture of metal mouldings and trim used in automobiles. Two of the taxpayers, C. P. Chamberlin and his wife, together owned 83.8 per cent of the stock, and were respectively the president and secretary of the corporation. Together with another taxpayer they constituted three of the four directors of the corporation. (R. 52-53.)

The corporation enjoyed substantial net earnings in each year from 1937 through 1945, paid cash dividends in those years, and had a substantial earned surplus at the end of 1945. For the first six months of 1946 the net profits after taxes amounted to $215,184.84, and for the entire year 1946 they amounted to $664,798.30. As of June 30, 1946, the corporation's balance sheet reflected total assets of $2,488,836.53, including $1,272,354.56 in cash and Government securities, of which $1,267,566.77 represented earned surplus. (R. 54, 57-58.)

In the latter part of 1945 a representative of the corporation conferred with one Flower, partner of an investment banking firm, regarding income tax problems of the corporation and its stockholders. It was explained that because of its large accumulated earned surplus the corporation was fearful

of being subjected to the surtax imposed by Section 102 of the Internal Revenue Code, and that C. P. Chamberlin, the majority stockholder, was unwilling to have the corporation distribute any substantial portion of the earned surplus as ordinary dividends because his individual income was taxable at high surtax rates. Advice was sought as to a means whereby the stockholders could derive cash benefits from the corporation's earned surplus in the form of capital gains rather than as taxable dividends. Flower suggested capitalization of a million dollars of the earned surplus through issuance of preferred stock, subject to provisions for rapid retirement, as a stock dividend to the stockholders, and an immediate sale of the preferred stock to an insurance company for cash. Chamberlin assented to this plan, and Flower then discussed it with an official of the Lincoln National Life Insurance Company. The latter stated he was interested if terms satisfactory to Lincoln could be worked out. Thereafter Chamberlin sought and received legal advice on the proposed plan, and in October 1946 Lincoln was advised of the Metal Company's willingness to make any reasonable covenants for the protection of the preferred stock, and of its wish to proceed with the plan before the end of the year. Shortly thereafter the Lincoln official inspected the plant and business of the Metal Company, discussed the proposed plan, and suggested amendments in accordance with Lincoln's investment policy. On November 11, 1946, that official made a detailed report to Lincoln regarding

the Metal Company's facilities, operations and earnings. His report stated, among other things, that the "purpose of this [issue of preferred stock] is to enable the owners to take money out of the company and to pay thereon a capital gains tax of 25 per cent rather than the normal personal income tax rates"; and that the negotiated terms of the preferred stock "seek to give the degree of protection usually found in a first lien bond issue." (R. 61-62.)

On November 20, 1946, Lincoln wrote to Flower that its finance committee approved of an $800,000 preferred stock issue and the purchase of one-half thereof on prescribed terms as to dividend rate, sinking fund, etc. Thereupon Flower communicated with the Northwestern Mutual Life Insurance Company, giving all the details of the plan and soliciting Northwestern's purchase of the other one-half of the proposed preferred stock issue. Northwestern made a detailed investigation of the Metal Company and of the terms and conditions of the proposed stock issue. About the middle of December its committee on investments approved the purchase of $400,000 of the preferred stock and turned the matter over to its legal department for consummation of the transaction. (R. 62-63.)

On December 16, 1946, the taxpayers authorized an increase of the Metal Company's authorized capital stock from $150,000 to $650,000, represented by 6,500 shares of $100 par value common stock, and a certificate to that effect was duly filed. On December 20, a common stock dividend was issued

to the taxpayers, resulting in an increase in the outstanding common stock from 1,002.5 to 6,015 shares, and a transfer of $501,250 of the corporation's surplus to capital account. (R. 54.)

On December 26, 1946, pursuant to the prior negotiations and the prearranged plan, taxpayers authorized an increase of the authorized capital stock of the Metal Company to a total of 14,520 shares of all classes of stock, consisting of 8,020 shares of four and one-half percent cumulative $100 par value preferred and 6,500 shares of $100 par value voting common. A certificate amending the corporation's charter to that effect was filed December 27. On the following day, December 28, pursuant to resolutions adopted by the stockholders and directors, a stock dividend of one and one-third shares of the newly authorized preferred stock was issued for each share of common outstanding, and the corporation's accounts were adjusted by transferring the par value of the preferred stock so issued (a total of $802,000) from earned surplus to capital account. On the same date, temporary typewritten preferred stock certificates were issued to taxpayers. (R. 54-56, 61.)

The preferred stock contained numerous terms and conditions designed to protect the holders. Among other things, the corporation reserved the right to redeem the shares in whole or in part on any dividend date, and it was required to redeem them between 1948 and 1954 in the amount of 2,000 shares in 1948 and 1,000 shares annually thereafter. (R. 55.)

On December 30, 1946, also as the result of the prior negotiations, the taxpayers signed a "Purchase Agreement" with the two insurance companies. It provided that the taxpayers "hereby confirm their agreement" for the sale of 4,000 shares of preferred stock to each of the insurance companies, at a cash price equal to the par value ($100 per share) plus dividends accrued to the date of delivery. Each of the insurance companies likewise "confirmed and accepted" that agreement. The Metal Company signed an endorsement of the agreement for the stated purpose of making "to and with" the insurance companies "the representations, warranties and agreements contained" in enumerated sections of the agreement and relating to the Metal Company's operations and financial condition. On the same day, December 30, taxpayers delivered the temporary preferred stock certificates endorsed in blank to the agents of the two insurance companies. The latter paid the purchase price to Chamberlin, who after deducting expenses incident to the sale distributed the cash proceeds pro rata among the taxpayers. On the same day, the temporary preferred stock certificates were delivered to and canceled by the corporation, and new temporary certificates were issued to the insurance companies. In April of the following year these temporary certificates were replaced by definitive stock certificates. (R. 58-60.)

Both the issuance of the preferred shares as a stock dividend to taxpayers, and the latters' imme-

diate sale of the dividend shares to the insurance companies, were the culmination of the prior negotiations directed toward that result. (R. 61.) No formal purchase agreement was entered into with the insurance companies prior to the "Purchase Agreement" executed on December 30, 1946. However, the stockholders and directors of the corporation took the necessary steps to put the negotiated plan into effect only after the insurance companies signified their willingness to purchase the preferred stock if, as, and when it was issued on the terms and conditions prescribed by them, and as set out in the corporation's amended charter and in the "Purchase Agreement" executed on December 30, 1946. (R. 63.)

In 1949 the authorized preferred stock of the Metal Company was decreased by 2,000 shares which had previously been retired. In 1950 the authorized preferred stock was again decreased by an additional 1,000 shares which had also been retired. (R. 60-61.)

In their 1946 income tax returns each of the taxpayers reported his proportion of the cash proceeds derived from the issuance and concurrent sale of the preferred stock as net long-term capital gain. The Commissioner determined that the amount received by each taxpayer constituted a dividend taxable as ordinary income. (R. 63.) The Tax Court, one judge dissenting, sustained the Commissioner's determination. (R. 64-78.) The Court of Appeals reversed. (R. 103.)

SPECIFICATION OF ERRORS TO BE URGED

The Court of Appeals erred:

1. In failing to apply to the facts of this case the established principle that the substance rather than the form of a transaction is determinative of its tax effect.

2. In holding that the Tax Court was precluded from finding that the issuance of the preferred stock to the taxpayers and the concurrent retransfer of the stock for cash to previously selected purchasers on previously negotiated terms, pursuant to a preconceived tax avoidance plan, were component steps of a single integrated transaction.

3. In substituting its inferences of fact for those of the Tax Court.

4. In holding that the transaction here involved resulted in the receipt by taxpayers of a non-taxable stock dividend.

5. In reversing the decision of the Tax Court.

REASONS FOR GRANTING THE WRIT

This case presents the important question of whether the controlling stockholders of a corporation may defeat the dividend tax by disguising what in substance and effect is a cash distribution of corporate earnings as a stock dividend and a sale of the dividend stock. Looking through form to substance, the Tax Court concluded that what appeared superficially to be two separate and distinct transactions—the issuance of a preferred stock dividend to the taxpayers-stockholders, followed by a sale of the stock to third parties—were actually

interrelated component steps in a single prearranged transaction, the avowed purpose of which was tax avoidance and the net result of which was to place the preferred stock in the hands of the purchasers, place the cash purchase price in the hands of the taxpayers, and reduce the corporation's accumulated earnings in the same amount.

The Court of Appeals, isolating the issuance of the preferred stock to the taxpayers from their concurrent retransfer of it to the purchasers, and treating the two steps as if they were unconnected events each having separate tax significance, reversed the Tax Court. It held that the taxpayers received a true stock dividend and, moreover, the kind of stock dividend which did not represent income constitutionally subject to tax. In so holding, the court below violated the fundamental principle, established by many decisions of this Court, that tax consequences flow from the substance rather than the form of a transaction. And it departed from the equally established rule that whether various steps in a transaction are in fact separate or interrelated presents a question of fact for the trial tribunal. The decision below sanctions a transparent attempt by stockholders of a closely held corporation to circumvent dividend tax liability through issuance of what is in form a stock dividend but is in substance a cash distribution of corporate earnings. If permitted to stand, it will invite widespread adoption of similar tax avoidance schemes, and result in serious loss of revenue.

1. Section 22 (a) of the Internal Revenue Code (Appendix, *infra*, p. 26) requires the inclusion

of "dividends" in gross income. Section 115 (a) (Appendix, *infra*, p. 26) defines a dividend as *any* distribution by a corporation to its shareholders, whether in money or other property, out of either accumulated or current earnings. By virtue of Section 115(b) (Appendix, *infra*, pp. 26-27), every distribution is deemed made out of earnings to the extent that the corporation has earnings. These provisions are qualified by Section 115(f) (Appendix, *infra*, p. 27), which provides in effect that a distribution in stock of the corporation is to be treated as a dividend only to the extent that it constitutes "income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution." See, also, Sections 29.115-1 and 29.115-7 of Treasury Regulations 111 (Appendix, *infra*, pp. 28-29). The provisions of Section 115(f) come into play only where there is a bona fide stock dividend, and whether such a dividend constitutes taxable income depends on whether it produces a change in the pre-existing proportionate interests of the stockholders. *Eisner* v. *Macomber*, 252 U. S. 189; *Koshland* v. *Helvering*, 298 U. S. 441; *Helvering* v. *Gowran*, 302 U. S. 238; *Helvering* v. *Griffiths*, 318 U. S. 371; *Helvering* v. *Sprouse*, 318 U. S. 604; *Strassburger* v. *Commissioner*, 318 U. S. 604. [2]

Addressing itself to the "substance of the trans-

[2] In the *Macomber* case, the Court said (p. 206) that the test of whether a stock dividend constitutes taxable income must be applied "according to truth and substance, without regard to form," and it emphasized (p. 211) that it was "considering the taxability of *bona fide* stock dividends only." The history of the taxation of stock dividends is summarized in the Tax Court's opinion. (R. 66-69.)

action" (R. 70), and pointing out that the "real purpose of the issuance of the preferred shares was concurrently to place them in the hands of others not then stockholders" (R. 72), the Tax Court concluded from all the evidence that the preferred stock dividend "was not a true stock dividend, but the equivalent of a cash dividend distribution out of available earnings" (R. 73). This conclusion is unquestionably warranted by the evidentiary facts.

Taxpayers were the common stockholders of a family corporation which had an earned surplus of more than a million dollars in cash and other liquid assets. They wished to derive the benefit of a cash dividend, but because their individual incomes were taxable at high surtax rates they also wished to escape the dividend tax to which they would be subject upon a direct distribution of the corporate earnings. In the hope of achieving both objectives, they devised a plan whereby they would cause the corporation to issue a preferred stock dividend, which they would simultaneously sell to third parties for cash. Pursuant to this plan, they negotiated with two insurance companies for a sale of preferred stock to be issued by the corporation. The negotiated terms of the proposed preferred stock issue were designed to afford the insurance companies the same degree of protection accorded holders of first lien bonds. The corporation reserved the right to redeem the stock at any time, and was required to do so within seven and a half years. After all the material

terms and conditions of the proposed preferred stock were negotiated with and approved by the insurance companies, both steps in the plan were executed: shares of preferred stock of a par value of $800,000 were issued to taxpayers, and the shares were contemporaneously sold to the previously selected purchasers upon the previously negotiated terms for an equal amount of cash.

The preliminary issue of the preferred stock to the taxpayers served no corporate or business purpose. The transaction admittedly was couched in the form of a stock dividend and a resale of the dividend stock in an attempt to relieve taxpayers of the dividend tax. Not a single practical result was accomplished by having the taxpayers take title to the stock, only to retransfer it to the purchasers, which would not have been achieved by having the corporation sell the stock directly to the purchasers. At the conclusion of the transaction the insurance companies owned $800,000 par value preferred stock, taxpayers received cash of an equivalent amount, and the corporation's earned surplus was decreased (and its capital increased) in the same amount. This was precisely the situation in which the parties would have found themselves had the corporation sold its preferred stock directly to the insurance companies and distributed the cash proceeds as a dividend.

Under the circumstances, the Tax Court was fully justified in concluding that the issuance of the preferred stock to taxpayers was not a bona fide stock dividend, the taxability of which is to be

tested by Code Section 115 (f) and cases dealing with genuine stock dividends. The distribution was clearly a taxable dividend within the purview of Section 115 (a) and (b). The transitory ownership of the dividend stock by taxpayers, and the circuitous routing of title to the purchasers, were steps designed to cloak the true nature of the transaction. If, as has been frequently stated by this Court, tax consequences depend on economic realities rather than on formal technical arrangements adopted for purposes of tax avoidance, the Tax Court should not have been reversed. The conclusion is inescapable that what really occurred here was a sale by the corporation of the new preferred stock to the insurance companies; the stockholders acted merely as a conduit of title from their corporation to the purchasers, while the purchase price payable to the corporation was deducted from its earned surplus and paid over directly to the stockholders.

2. In disagreeing with the Tax Court, the court below in effect rested its decision upon a combination of two theories: (1) the issuance of the preferred stock to taxpayers must be treated as a transaction separate and distinct from the concurrent transfer of the stock to the purchasers, and hence must be viewed as a true stock dividend for purposes of applying Section 115 (f); (2) so viewed, the stock dividend did not represent constitutionally taxable income in taxpayers' hands, and, hence, was exempt from dividend tax under that section. In both respects the decision below

is in conflict with controlling decisions of this Court.

(a) In so far as the decision below is predicated on the assumption that the issuance of the preferred stock must be divorced from the contemporaneous sale, it departs from the settled principle that the substance rather than the form of a transaction is determinative of its tax effect, and the corollary doctrine that literal compliance with a tax exemption provision does not necessarily suffice to bring a transaction within it. To permit the device here employed to insulate taxpayers from dividend tax would indeed sanction the kind of formalism which this Court has repeatedly condemned as ineffectual to escape or reduce tax liability. *Commissioner* v. *Court Holding Co.*, 324 U. S. 331; *Gregory* v. *Helvering*, 293 U. S. 465; *Minnesota Tea Co.* v. *Helvering*, 302 U. S. 609; *Bazley* v. *Commissioner*, 331 U. S. 737; *Griffiths* v. *Commissioner*, 308 U. S. 355; *Higgins* v. *Smith*, 308 U. S. 473; *United States* v. *Joliet & Chicago R. Co.*, 315 U. S. 44.

In the *Court Holding* case, *supra*, a corporation distributed its property to its stockholders in the form of a tax-free liquidating dividend, and the stockholders in turn sold the property to a purchaser with whom prior negotiations had taken place, both steps being taken pursuant to a plan to reduce tax liability. This Court held that the Tax Court was fully warranted in viewing the entire transaction as if the property had been sold directly by the corporation to the purchaser, and

as if the corporation had received the cash price and had distributed it to the stockholders, notwithstanding that legal title to the property first passed to the stockholders who then made the sale in their own names. The Court stated that (p. 334)—

> the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.

The Tax Court was here likewise justified in viewing the transaction "as a whole," and in concluding that the temporary passage of title to the preferred stock to the stockholders was but an intermediate formal step, designed to mask a taxable dividend distribution as a tax-free stock dividend and resale of the dividend stock.

In the *Minnesota Tea* case, *supra,* a corporation sought to come within a provision exempting from tax the gain upon a reorganization to the extent that cash received in the transaction was distributed to the stockholders. The cash was actually distributed by the corporation to its stockholders, but in accordance with a prior understanding the stockholders used it to pay debts of

the corporation. In oft-repeated language this Court stated (pp. 613-614):

> A given result at the end of a straight path is not made a different result because reached by following a devious path. The preliminary distribution to the stockholders was a meaningless and unnecessary incident in the transmission of the fund to the creditors, all along intended to come to their hands, so transparently artificial that further discussion would be a needless waste of time. The relation of the stockholders to the matter was that of a mere conduit.

The end result of the various steps here employed—issuance of preferred stock to the taxpayers and retransfer of it to the previously selected purchasers—was no different than if the corporation had sold the stock directly to the purchasers and distributed the cash proceeds to the taxpayers. In the words of the *Minnesota Tea* case, "the preliminary distribution to the stockholders was a meaningless and unnecessary incident in the transmission" of the stock to the purchasers, and "the relation of the stockholders to the matter was that of a mere conduit."

In the *Gregory* case, *supra*, a taxpayer desiring to withdraw securities from a wholly owned corporation without being taxed with the receipt of a dividend formed another corporation to which the securities were transferred, and the new corporation was then liquidated and the securities distributed to the taxpayer. There was no doubt

that, as a literal matter, these steps did not constitute a dividend distribution and that they did comply with the statutory terms describing a nontaxable reorganization. The Court nevertheless held that a taxable dividend was distributed by the original corporation to the taxpayer. Measuring "what actually occurred" against what "the statute intended", it stated that the arrangement was (p. 469)—

> Simply an operation having no business or corporate purpose—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner.

To paraphrase the above language, the preliminary issuance of the preferred stock to the stockholders in the instant case was a mere device to conceal a sale of the stock by the corporation; the sole object and effect of the arrangement was the consummation of a preconceived plan, not to distribute the stock to the taxpayers as a stock dividend, but to sell it to third parties for cash and enable taxpayers to realize the cash benefits. While the taxpayer in *Gregory* attempted a plan which would give the appearance of a nontaxable "reorganization" and the taxpayer here attempted a plan which would give the appearance of a nontaxable stock dividend, the cases are parallel in that, when

the ultimate objective was accomplished, the stockholders in each had, though indirectly, managed to realize on the corporation's earnings while retaining their original stock interests.

The decision below is also in conflict with decisions of other Courts of Appeals which refuse to accord tax effect to step transactions designed to disguise a taxable event. *Meurer Steel Barrel Co.* v. *Commissioner,* 144 F. 2d 282 (C. A. 3d), certiorari denied, 324 U. S. 860; *Kaufmann* v. *Commissioner,* 175 F. 2d 28 (C. A. 3d); *Fairfield S. S. Corp.* v. *Commissioner,* 157 F. 2d 321 (C. A. 2d), certiorari denied, 329 U. S. 774; *Embry Realty Co.* v. *Glenn,* 116 F. 2d 682 (C. A. 6th); *Hellebush* v. *Commisisoner,* 65 F. 2d 902 (C. A. 6th); *Wichita Term. El. Co.* v. *Commissioner,* 162 F. 2d 513 (C. A. 10th).

(b) Even if it be assumed that the issuance of the preferred stock and the concurrent sale of it were independent transactions, it still would not follow, as the court below further assumed, that the stock dividend was not a taxable one under Section 115(f). That section exempts from the dividend tax only those stock dividends which do not constitute income within the meaning of the Sixteenth Amendment to the Constitution. In holding that the preferred stock which taxpayers here received as a dividend did not represent constitutionally taxable income, the court below has misconceived and consequently misapplied the decisions of this Court in cases dealing with the taxability of stock dividends. Nothing in the deci-

sions upon which the court below relied justifies the view that common stockholders do not realize taxable income where they receive preferred stock which for all practical purposes is the equivalent of cash, and in fact is converted into cash immediately upon its receipt. [8]

On this aspect of the case, the decision below conflicts in principle with *Bazley* v. *Commissioner*, 331 U. S. 737. See also *Adams* v. *Commissioner*, 331 U. S. 737. There the controlling stockholders of a corporation exchanged their stock for new stock and debentures of the corporation, and claimed that this constituted a "recapitalization" which qualified as a non-taxable reorganization within the meaning of Code Section 112(b) and (g). This Court agreed that what took place was a reorganization in the literal sense. However, it pointed out that Congress, in making such transactions non-taxable, was concerned with situations where the exchange of securities (p. 740) "represents merely a new form of the previous participation in an enterprise" and involves "no change of substance in the rights and relations of the interested parties one to another or to the corporate assets". Observing that (p. 743) "nothing was accomplished that would not have been accom-

[8] Thus in *Strassburger* v. *Commissioner*, 318 U.S. 604, which the court below apparently deemed controlling here, this Court noted (p. 607) that the taxpayer (the sole stockholder) "still holds the preferred stock", that he "owned exactly the same interest in the net value of the corporation as before", and that he "retained all the incidents of ownership he had enjoyed before". No such situation is here presented. See also *Koshland* v. *Helvering*, *supra*, and *Helvering* v. *Gowran*, *supra*.

plished by an outright debenture dividend", and that a reorganization "which is merely a vehicle, however elaborate or elegant, for conveying earnings from accumulations to the stockholders" is not a non-taxable exchange, the Court held that the shareholders received a taxable dividend equal to the value of the debentures. The Court said (p. 742):

> In the case of a corporation which has undistributed earnings, the creation of new corporate obligations which are transferred to stockholders in relation to their former holdings, so as to produce, for all practical purposes, the same result as a distribution of cash earnings of equivalent value, cannot obtain tax immunity because cast in the form of a recapitalization-reorganization. * * *
>
> * * * The debentures were found to be worth at least their principal amount, and they were virtually cash because they were callable at the will of the corporation which in this case was the will of the taxpayer. * * *

The preferred stock which taxpayers here received was no less tantamount to a cash distribution of earnings than the debentures received by the taxpayers in the *Bazley* case. Under the rationale of the *Bazley* decision the instant case is indeed an *a fortiori* one for treating the securities received as a taxable dividend. Not only was the preferred stock redeemable at the will of the corporation (as were the debentures in *Bazley*), but it was subject to mandatory redemption within

seven and one-half years. (R. 55.) [4] Furthermore, the terms of the preferred stock were designed to meet the investment requirements of the purchaser-insurance companies, so as "to give the degree of protection usually found in a first lien bond issue". (R. 62, 71.) What is more, even prior to the declaration of the preferred stock dividend, taxpayers had arranged to transfer it to the purchasers for cash. That the stock was worth its face amount in cash is conclusively demonstrated by the fact that, contemporaneously with its receipt, it was exchanged for cash of an equivalent amount.

While in the *Bazley* case the debentures were issued to the common stockholders through the medium of a "recapitalization", and in this case preferred stock was issued by way of a "stock dividend", the underlying question is essentially the same and the reasoning in *Bazley* applies here with full force. Indeed, where the new securities consist of stock, the difference between a recapitalization and a stock dividend is purely one of form, the old stock certificates being surrendered in the former but not the latter transaction. The kind of stock dividend which Congress intended should be tax-free under Section 115(f), like the kind of recapitalization which the Court in *Bazley* held was intended to be tax-free under Section 112, is that which does not substantially alter the preexisting interests of the stockholders. Section 115(f) no more furnishes a vehicle for circumvent-

[4] The debentures in *Bazley* and *Adams* had a maturity of 10 and 20 years, respectively.

ing a dividend tax on what is essentially equivalent to a cash distribution of corporate earnings than does Section 112.

3. The decision below is also in conflict with rules governing the scope of appellate review of the trial court's factual determinations. *Commissioner* v. *Court Holding Co.*, 324 U. S. 331; *United States* v. *Cumberland Pub. Serv. Co.*, 338 U. S. 451; *Dobson* v. *Commissioner*, 320 U. S. 489; *Wilmington Co.* v. *Helvering*, 316 U. S. 164; *Commissioner* v. *Scottish American Co.*, 323 U. S. 119. "Whether an apparently integrated transaction shall be broken up into several separate steps and whether what apparently are several steps shall be synthesized into one whole transaction is frequently a necessary determination in deciding tax consequences." *Dobson* v. *Commissioner, supra*, p. 502. "It is for the trial court upon consideration of an entire transaction, to determine the factual category in which a particular transaction belongs". *United States* v. *Cumberland Pub. Serv. Co., supra*, p. 456. And the trial court's conclusion may not be disturbed unless it is "clearly erroneous". Rule 52(a), Federal Rules of Civil Procedure.

Although the court below recognized that (R. 102) "each case necessarily depends upon its own facts," it proceeded to substitute its own inferences for those of the Tax Court. Disregarding the circumstances which impelled the Tax Court to conclude that the stock dividend in question was neither a bona fide stock dividend nor a nontaxable one, it

treated the issuance of the stock and the concurrent sale of it as if they were two independent transactions, each falling in a separate tax compartment. In effect it held that the Tax Court was precluded by the form in which the transaction was cast from finding that the two events were connected links in a single chain, and was obliged as a matter of law to isolate one step from the other.[5]

4. The issue in this case is an important one in the interpretation and administration of the taxing statute, the answer to which will have a serious impact upon the revenues. It amounts to nothing less than whether the controlling stockholders of a corporation may insulate themselves from ordinary income tax liability on what is essentially a cash dividend distribution simply by creating the surface appearance of a non-taxable preferred stock dividend. During the past several years attempts to achieve such immunity have been unavailing.[6] The decision below if left unchallenged will

[5] In stressing (R. 99-102) that the preferred stock constituted real stock the court below addressed itself to a straw issue. The critical questions are (1) whether the stock was really issued to the taxpayers, or sold to the transferee-purchasers; and (2) even if regarded as having been issued to taxpayers, whether it was nevertheless the equivalent of a cash dividend.

[6] The Chief Counsel of the Internal Revenue Service has advised the Department of Justice that "the decision in the instant case undermines the accepted tax policy of the last five years, and will result in the development of many devices for the use of preferred stock bail-outs to the distortion of normal business transactions and to the detriment of sound tax administration." (Letter dated December 17, 1953, from Daniel A. Taylor to Assistant Attorney General H. Brian Holland). The writers who have considered the kind of situation presented by this case have hitherto agreed that the stockholders are taxable with the receipt of ordinary dividend income.

open a wide avenue of escape from the dividend tax, and will undoubtedly lend impetus to the adoption of similar tax avoidance schemes by stockholders of family corporations. Unless the question is authoritatively resolved by this Court, the decision below may be expected to furnish a prolific source of tax litigation in the future.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

ROBERT L. STERN,
Acting Solicitor General.

JANUARY, 1954.

DeWind, Preferred Stock "Bail-outs" and the Income Tax, 62 Harv. L. Rev. 1126 (1949); Platt, Preferred Stock Dividends and Recapitalizations after the Bazley and Adams cases, N.Y.U. Seventh Annual Institute on Federal Taxation 561 (1949); DeWind, Preferred Stock Dividends and Recapitalizations, N.Y.U. Eighth Annual Institute on Federal Taxation 236 (1950); Stockholder Realization of Corporate Earnings and the Income Tax, 17 U. Chi. L. Rev. 338, 351 (1950); and Darrell, Recent Developments in Nontaxable Reorganizations and Stock Dividends, 61 Harv. L. Rev. 958, 977 (1948).

APPENDIX

Internal Revenue Code:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains,, profits, and income derived from salaries, wages, or compensation for personal service * * *, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

(26 U.S.C. 1946 ed., Sec. 22.)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this chapter * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year * * * without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of Distributions.*—For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof,

and from the most recently accumulated earnings or profits. * * *

* * * * *

(f) *Stock Dividends.*—

(1) *General rule.*—A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution.

(2) *Election of shareholders as to medium of payment.*—Whenever a distribution by a corporation is, at the election of any of the shareholders (whether exercised before or after the declaration thereof), payable either (A) in its stock or in rights to acquire its stock, of a class which if distributed without election would be exempt from tax under paragraph (1), or (B) in money or any other property (including its stock or in rights to acquire its stock, of a class which if distributed without election would not be exempt from tax under paragraph (1)), then the distribution shall constitute a taxable dividend in the hands of all shareholders, regardless of the medium in which paid.

* * * * *

(j) *Valuation of Dividend.*—If the whole or any part of a dividend is paid to a shareholder in any medium other than money the property received other than money shall be

included in gross income at its fair market value at the time as of which it becomes income to the shareholder.

* * * * *

(26 U.S.C. 1946 ed., Sec. 115.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

Sec. 29.115-1. *Dividends.*—The term "dividend" for the purpose of chapter 1 * * * comprises any distribution in the ordinary course of business, even though extraordinary in amount, made by a domestic or foreign corporation to its shareholders out of either—

(1) earnings or profits accumulated since February 28, 1913, or

(2) earnings or profits of the taxable year computed without regard to the amount of the earnings or profits (whether of such year or accumulated since February 28, 1913) at the time the distribution was made.

* * * * *

A taxable distribution made by a corporation to its shareholders shall be included in the gross income of the distributees when the cash or other property is unqualifiedly made subject to their demands.

* * * * *

Sec. 29.115-7. *Stock Dividends.*—A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock

shall be treated as a dividend to the full extent that it constitutes income to the shareholders within the meaning of the sixteenth amendment to the Constitution. * * *

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